EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
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MEMORANDUM FOR THE CHIEF FINANCIAL OFFICERS, CHIEF OPERATION OFFICERS, CHIEF INFORMATION OFFICERS, PROGRAM MANAGERS, AND INSPECTORS GENERAL

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Controller

SUBJECT: Frequently Asked Questions Regarding OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A

Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, defines management's responsibility for internal control in Federal departments and agencies. In December 2004, OMB revised A-123 and introduced a new appendix, Appendix A, which prescribes a strengthened process to assess the effectiveness of the internal control over financial reporting.

The Chief Financial Officers Council (CFOC) Financial Management Policies and Practices Committee developed an implementation guide to assist agencies in meeting the strengthened requirements contained in Appendix A. The implementation guide was issued in final in late July and can be found on the CFOC web page, http://www.cfoc.gov/documents/Implementation_Guide_for_OMB_Circular_A-123.pdf. The implementation guide defines a five-step process for agencies to follow along with examples of best practices and templates of management assurance statements.

The attached frequently asked questions to Circular A-123, Appendix A are intended to provide additional insight into the requirements. These questions and answers, along with the implementation guide, are additional resources for facilitating compliance with these new requirements. The frequently asked questions can also be found on the OMB web page at www.whitehouse.gov/omb/financial.

If you have any questions regarding this memorandum, please contact the Office of Federal Financial Management at 202-395-3993.

Attachment

Attachment

I. General

1. Why did the Office of Management and Budget revise Circular A-123?

Effective internal control is the foundation for timely and reliable financial management information and fundamental to management accountability. The President's Management Agenda (PMA) emphasizes the need for effective internal control to routinely meet accelerated financial reporting goals and have accurate financial information readily available to manage programs. The new internal control requirements for public companies under the Sarbanes-Oxley Act of 2002, P.L. 107-204 (SOX), have also served as an impetus to review existing internal control requirements in the Federal Government.

With these things in mind, last year the Office of Management and Budget (OMB) convened a joint Chief Financial Officers Council (CFOC) and President's Council on Integrity and Efficiency (PCIE) committee to review the new internal control requirements for public companies under SOX and determine the appropriateness of these requirements in the Federal Government. The Federal Manager's Financial Integrity Act (FMFIA) and Circular A-123, *Management's Responsibility for Internal Control,* are at the center of internal control requirements in the Federal Government.

The joint CFOC/PCIE committee recommended that Circular A-123 be strengthened to require a more rigorous assessment of internal control over financial reporting. OMB accepted this recommendation and worked closely with the CFOC/PCIE working group to develop the revised circular.

2. What are the major changes?

The revised Circular A-123 requires a strengthened process for conducting management's assessment of the effectiveness of internal control over financial reporting based on widely recognized internal control standards. The strengthened process for conducting and documenting management's assessment of internal control over financial reporting is defined in Appendix A.

Implementing Appendix A requires management to take a proactive approach to assessing and improving internal control effectiveness. The assessment process requires: 1) end-to-end documentation of the process, 2) direct testing of key controls to determine operating effectiveness, and 3) a new assurance statement for internal control over financial reporting (as a subset of the overall FMFIA assurance statement). The revised Circular emphasizes the need for management to integrate its assessment, where possible, with other control-related activities already being performed.

3. What entities are covered under the Appendix A revisions?

The new requirements contained in Appendix A apply to the 24 CFO Act agencies. Component units are not required to be assessed separately, but should be included in the agency-wide assessment and assurance statement.

4. What is the effective date?

The revised Circular A-123 is effective beginning in fiscal year (FY) 2006. Agencies should take steps in FY 2005 to develop a detailed implementation plan for conducting the assessment process.

The first management assurance statement for internal control over financial reporting is required as of June 30, 2006, for inclusion in FY 2006 agency PARs, due 45 days after the end of the fiscal year. For entities that receive opinions on internal control over financial reporting, the first management assurance statement will be as of September 30, 2006.

II. Planning Management's Assessment

1. How is the Senior Management Council different from the Senior Assessment Team?

The Senior Management Council is responsible for advising the agency head on what deficiencies within the organization may be categorized as material weaknesses and reported externally. Agencies may also use the Senior Management Council to monitor corrective action milestones related to identified deficiencies to ensure resolution occurs in a timely manner. The Senior Management Council may include the Chief Financial Officer, Chief Information Officer, and the heads of other functional areas.

The Senior Assessment Team is a subset of the Senior Management Council under the direction of the Chief Financial Officer. The Senior Assessment Team is responsible for conducting and coordinating the internal control assessment process specifically related to financial reporting.

2. Who should conduct the assessment of internal control over financial reporting?

It is recommended, but not required, that agencies form a Senior Assessment Team to direct the assessment. OMB Circular A-123, Appendix A provides guidance on the functions and responsibilities of the Senior Assessment Team. The Senior Assessment Team should be under the direction of the CFO and should include executives from areas responsible for maintaining controls over key processes and systems.

Process owners most knowledgeable about the key processes and systems should be responsible for documenting those processes and systems and identifying key controls. The Senior Assessment Team should then designate individuals to review the documentation and perform tests to verify the controls are operating effectively.

3. What role does the Chief Information Officer (CIO) play in the assessment process?

A senior level representative from the Office of the Chief Information Officer should be a member of the Senior Assessment Team since documenting and assessing IT controls is a major component of the assessment process.

4. What is the scope of the assessment of internal control over financial reporting?

Management has discretion in determining both aspects – *breadth and depth* – of the scope of financial reporting. The *breadth* of financial reporting details the specific financial reports that are included in the scope. At a minimum, the breadth of financial reporting includes the annual and quarterly entity-wide financial statements and associated notes. At their discretion, management may expand the scope to include other key financial reports. The *depth* of financial reporting determines where the financial reporting processes meet the operating processes on an entity-wide basis as well as the extent of coverage at the component unit and multiple locations.

5. What types of management assurances are needed from component units in a large complex agency?

There is only one management assurance required as part of the PAR submission for Circular A-123 Appendix A, and that is at the department-wide level. The types of management assurances departments may require from component organizations will be directly related to the amount of test work performed, as determined by scope, risk, and materiality determinations made by management.

6. During its assessment, can management rely on SAS 70 reports issued by auditors of service organizations used by the agency?

Yes. An agency can leverage SAS 70 reports during the assessment. Management must consider if a Type II SAS 70 report exists and if it is sufficient in scope[1]. A Type II SAS 70 report is required of all federal entities that cross-service other federal entities per OMB Memorandum M-04-11, *Service Organization Audits*.

III. Testing

1. Do all key controls need to be tested annually?

Risk-based testing of key controls is permissible under certain circumstances. Once a baseline is established on the operating effectiveness of key controls, not all key controls

[1] Typically a Type II SAS 70 report is not sufficient on its own to satisfy the requirements under the Federal Information Security Management Act (FISMA).

must be tested every year[2]. The risk-based approach generally requires that controls are stable, there are no known deficiencies, and that controls will be tested at least every three years. Further, for fully automated controls, management is required to verify that adequate change control procedures are in effect. Management should document its risk-based testing plan and how the above circumstances are met.

IV. Reporting and Corrective Action Plans

1. How should the new assurance statement on internal control over financial reporting be reported in the PAR?

The annual assurance statement is reported in the PAR in the Management Discussion & Analysis (MD&A) section. This assurance statement is a subset of the FMFIA assurance statement currently required. The assurance statement (overall assurance with a separate reference to internal control over financial reporting) should be reported in a separate section in the MD&A section entitled "*Management Assurances*." A summary of material weaknesses and corrective actions should be included in an exhibit accompanying the assurance statement. If the material weakness has been corrected prior to PAR issuance, resolution can be reported if there has been time to perform adequate testing of the control.

2. What is the period covered by the assessment of internal control over financial reporting?

For those entities not receiving an opinion on internal control, management's assurance statement is provided as of June 30. Testing of controls to support management's assurance statement should be performed during the prior 12-month period that is July 1 to June 30. This means that the year-end financial reporting controls in place for the prior fiscal year will be included in the June 30 assurance. For those entities receiving an opinion on internal control, management's assurance is provided as of September 30.

3. What period is covered by the initial assurance statement prepared as of June 30, 2006?

The initial assurance statement for the first year of implementation will cover controls in place from October 1, 2005, to June 30, 2006. This means that management's assessment for this initial year will be limited to evaluating the design of the year-end controls.

4. Should the assurance statement provided as of June 30 be updated prior to being reported in the PAR in November?

Yes, changes in the control environment and effectiveness of controls may occur between June 30 and the end of the fiscal year. For example, management may implement new

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[2] FISMA, however, requires annual testing of "…the effectiveness of information security policies, procedures, and practices." See OMB Memorandum M-05-15, FY 2005 Reporting Instructions for the Federal Information Security Management Act and Agency Privacy Management, for additional guidance.

controls to address a material weakness reported as of June 30. In this example, management may perform additional procedures from June 30 to September 30 that validate the effectiveness of a new control and resolution of a material weakness previously reported. In this case, the material weakness is still reported in the PAR, but an explanation is provided indicating the weakness has been corrected and the new controls validated.

Similarly, while the testing of year-end controls is part of the next year's assessment, management's or an independent auditor's testing at year-end may reveal a material weakness that was not reported as of June 30. In this case, management should include the new material weakness in the updated assurance statement reported in the PAR.

5. What are the requirements for developing corrective action plans to remediate material weaknesses?

Corrective action plans are required for all material weaknesses, and progress against plans should be periodically assessed and reported to agency management. A summary of the corrective action plans for material weaknesses shall be reported to OMB and the Congress through the PAR. The summary discussion shall include a description of the material weakness and status of corrective actions with target completion dates. Corrective actions will continue to be monitored as part of the PMA Improving Financial Performance scorecard.

V. Management and Independent Auditor Interaction

1. How does the Circular A-123 internal control assessment process relate to the annual financial statement audit?

Management's documentation of controls, annual assessment, and any resultant corrective actions can have a positive effect on the annual financial statement audit. An audit of a well-documented system that is routinely monitored and adjusted by management will positively impact on the auditor's consideration of risk, and thereby, make the financial audit easier to plan and conduct. Conversely, the insights of the independent auditor into management's systems and the operating effectiveness of those systems can aid management in designing the appropriate nature, timing, and extent of testing required for its assessment.

2. Can auditors share documentation developed as part of the independent audit process?

Yes, certain information can be helpful to supplement and validate management's documentation. Having accurate and consistent documentation of key processes supports both management's assessment and the independent audit. However, receipt of information from an independent auditor would not remove management's responsibility for internal control design, adequacy, and related testing.

3. What recommended areas should be discussed with the Inspector General or outside auditors?

It is highly recommended that management consult with the agency Inspector General (IG) and independent financial auditors during key phases of the assessment. It is most critical to discuss significant planning decisions relating to:

- Scope of the work;
- Materiality and risk considerations;
- Identification of key processes and controls;
- Priority of key processes to test;
- Sampling methodology; and
- Timing of test-work to be performed.

4. What is an appropriate role for the agency Inspector General to play in the assessment process?

The IG should participate in an advisory capacity to the extent the IG feels its independence will not be compromised. The requirements of Circular A-123 are directed to agency management. The detailed assessment process for financial reporting controls must be performed by management not the IG or independent auditor. However, it is appropriate for agency IGs and other independent auditors to be consulted in regard to key management decisions during the planning phase of the assessment. Similarly, there may be efficiencies that could be achieved between work done by management in conducting their assessment and work performed by the IG or independent auditor in conducting the financial audit. To ensure good communication between management and independent auditors, it is appropriate for a representative from the agency's Office of Inspector General to be included as an ex-officio member of the Senior Assessment Team.